

# City of Detroit

## CITY COUNCIL

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ANNE MARIE LANGAN  
DEPUTY DIRECTOR  
(313) 224-1078

TO: Councilmembers

FROM: Irvin Corley, Jr., Director *ICJ*  
Anne Marie Langan, Deputy Director *AML*

DATE: February 5, 2010

RE: Resolution Amending and Supplementing a Prior Resolution  
Approving Transactions Under Certain Interest Rate Exchange  
Agreements Entered into in Connection with Related Outstanding  
and Future Sewage System Bonds of the City of Detroit and  
Related Outstanding and Future Water System Bonds of the City of  
Detroit.

At last week's Budget Finance and Audit Committee, there was a line item from the Finance Department asking that Council authorize a resolution extending a swap resolution that had initially been approved by Council on April 7, 2006 for a period through March 1, 2010. The extension that is requested is through July 1, 2013. It was requested by Councilmember Brown that this office provide a written explanation on this issue.

Currently it is the advice of the Finance Department that the best option for the city right now is to extend the swap agreement. If Council chooses not to extend the swap agreement, it would expire. However at this time the swap instrument is not in the city's favor and therefore if terminated the city would owe a payment of \$93 million. The city will not owe this amount at this time if the extension is granted.

Attached for your review are pages 110 through 114 of the most recently completed Comprehensive Annual Financial Report (CAFR) of 2008 that was just completed in December 2009. These pages explain the city's position of interest rate swaps. The city is currently part of 32 individual interest rate swaps. The four that relate to this report are the ones for Sewage and Water that are circled.

At the time the city entered into these swaps in 2006, the explanation relayed to our office was that DWSD had a significant capital program that would continually need additional bonding, the interest rates were close to 6% and by entering into this swap agreement, the interest rate would be at 4.93%. After this agreement

was in place, DWSD was granted the ability to sell bonds for capital projects through the Michigan Department of Environmental Quality (MDEQ) and the interest rate was 2.5%, which was even more favorable. This is why this option was not used and now the city is in the position of needing to extend it.

We have submitted the following questions to Finance and are expecting responses soon:

1. Please explain how the city came to the conclusion in 2003 that swap agreements would be a good thing for controlling costs in the DWSD capital programs?
2. How many swap agreements have we had like this, and what has been the financial outcome for each of them? Please list all existing swaps and what we have to pay for them.
3. For the specific swap extensions currently before Council, how much have we paid? Does the payment change each month? Sometimes is the city getting paid? Is this swap a different type of swap from the swap entered into for the POCs?
4. Why didn't we sell bonds during this time period -2006 to 2010? What if we don't sell bonds before it expires again? What are the chances that the MDEQ financing will come through at a better rate, again, thereby the city holding on to this swap for a locked interest rate and not using it?
5. If the swap turns in the city's favor, is the plan to cash it in, even without selling bonds?
6. So the current choices the city has are the following: 1. Extend the swap through 2013, with council authorization and continue to monitor the swap; 2. Sell bonds before the expiration date of the swap and roll the cost into bond sale; 3. Allow the swap to expire and currently the city would owe \$93 Million. Is that correct?

Below are some additional questions that we would like responses to:

7. How many municipalities enter into these types of agreements, and is it still prudent for the city to continue this policy? Can you show us the analysis performed that presented this as the fiscally responsible method of rate setting?
8. On page 178 of the 2008 CAFR there is a SWAP Termination Fee from 2006 of \$38 million. Please explain what this is.
9. If the Council were to vote no on this resolution extending this swap agreement, how would this affect water and sewerage rates?

10. What is the new administration's position on this swap policy?

It seems that it has been known for some time that this swap was going to need an extension. The administration should explain why this resolution, which is quite a complex financial instrument, would come before Council just weeks before it is to expire. Especially after the crisis of the swap agreements that were in place because of the POCs, it would seem logical that Council would require a more in depth explanation of the situation. We would recommend that the Finance Department prepare a written report explaining the swap policy and how it benefits the city's finances.

We appreciate the Finance Department's request that Council authorize this resolution. We think that it would benefit everyone for Council to see the responses to the above questions prior to voting.

**Attachments**

cc: Council Divisions  
Auditor General  
Norman White, Chief Financial Officer  
Tom Lijana, Finance Director  
Donita Crumpler, Debt Manager

January 14, 2010

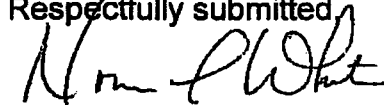
Honorable City Council:

**A Resolution Amending and Supplementing A Prior Resolution Approving Transactions Under Certain Interest Rate Exchange Agreements Entered into in Connection with Related Outstanding and Future Sewage System Bonds of the City of Detroit and Related Outstanding and Future Water System Bonds of the City of Detroit.**

In 2006 Council approved certain interest rate exchange agreements to lock in comparatively low interest rates for securities to be issued for both the Water Supply and the Sewage Disposal Systems in the 2009 calendar year. Neither Sewage System nor Water System Bonds were issued in the 2009 calendar year as contemplated by the 2006 Swap Resolution; nor is there intent to issue any such bonds within 90 days of the March 1, 2010 and April 1, 2010 effective dates of the swap confirmations. Attached resolution extends the effective dates of the confirmations, in lieu of terminating them.

Bond Counsel has prepared the attached Resolution and I recommend its adoption by your Honorable Body, with waiver of reconsideration, at your next formal session.

Respectfully submitted,



Norman L. White  
Finance Director

NLW/dc

Cc: Kamau Marable  
Denise Gardner  
Irvin Corley  
David Whitaker

**A Resolution Amending and Supplementing A Prior Resolution Approving Transactions Under Certain Interest Rate Exchange Agreements Entered into in Connection with Related Outstanding and Future Sewage System Bonds of the City of Detroit and Related Outstanding and Future Water System Bonds of the City of Detroit.**

By Council Member \_\_\_\_\_:

**Whereas**, on April 7, 2006, this City Council (the "**Council**") of the City of Detroit (the "**City**") adopted a resolution (the "**2006 Swap Resolution**") which authorized the Finance Director to execute confirmations under Approved Interest Rate Exchange Agreements and to make certain determinations in connection therewith, subject to the parameters contained therein; and

**Whereas**, the 2006 Swap Resolution contained recitals which anticipated the issuance of future Sewage Disposal System Revenue Bonds ("**Sewage System Bonds**") and Water Supply System Revenue Bonds ("**Water System Bonds**") during the 2009 calendar year and authorized the utilization of Interest Rate Exchange Agreements to effectively lock in comparatively low interest rates existing at the time of the 2006 Swap Resolution for Sewage System Bonds and Water System Bonds to be issued in the future; and

**Whereas**, pursuant to the 2006 Swap Resolution, the City entered into Confirmation AUE7R with respect to Sewage System Bonds, pursuant to the ISDA Master Agreement and related Schedule dated as of May 22, 2003 (Sewer System Transactions), as amended and supplemented from time to time, and Confirmation No. AUE7V with respect to Water System Bonds, pursuant to the ISDA Master Agreement and related Schedule dated as of May 22, 2003 (Water System Transactions), as amended and supplemented from time to time, each between Morgan Stanley Capital Services Inc. ("**Morgan Stanley**") and the City (such Confirmations are collectively, the "**Morgan Stanley Confirmations**" and such ISDA Master Agreements and related Schedules are collectively, the "**Morgan Stanley ISDA Agreements**"); and

**Whereas**, pursuant to the 2006 Swap Resolution, the City entered into Confirmation SBSFPC-0006 with respect to Sewage System Bonds, pursuant to the ISDA Master Agreement and related Schedule dated as of April 26, 2006 (Sewer System Transactions), as amended and supplemented from time to time, and Confirmation No. SBSFPC-0007 with respect to Water System Bonds, pursuant to the ISDA Master Agreement and related Schedule dated as of April 26, 2006 (Water System Transactions), as amended and supplemented from time to time, each between SBS Financial Products Company, LLC ("**SBS**") and the City (such Confirmations are collectively, the "**SBS Confirmations**" and such ISDA Master Agreements and related Schedules are collectively, the "**SBS ISDA Agreements**"); and

**Whereas**, both the Morgan Stanley Confirmations and the SBS Confirmations provide that they are to have an effective date of no later than March 1, 2010; and

**Whereas**, the 2006 Swap Resolution contains parameters for additional Forward Transactions authorized herein, included among which is that the effective date for each Forward Transaction shall not be later than April 1, 2010; and

**Whereas**, the 2006 Swap Resolution requires that if (i) Future Related Securities related to a Forward Transaction are not issued within 90 days of the effective date of such Forward Transaction and (ii) the notional amount of such Forward Transaction is not assigned to another Forward Transaction, the Forward Transaction is to be terminated; and

**Whereas**, the City did not issue Sewage System Bonds or Water System Bonds in the 2009 calendar year as contemplated by the 2006 Swap Resolution and does not intend to issue any such bonds within 90 days of the March 1, 2010 effective date of the Morgan Stanley Confirmations and the SBS Confirmations; and

**Whereas**, the City contemplates the issuance of Sewage System Bonds and Water System Bonds to which it can relate the Morgan Stanley Confirmations and the SBS Confirmations on or before July 1, 2013; and

**Whereas**, it is not in the City's best financial interest to terminate the Morgan Stanley Confirmations and the SBS Confirmations on or before March 1, 2010; and

**Whereas**, Morgan Stanley and SBS have indicated a willingness to extend the effective dates of the Morgan Stanley Confirmations and the SBS Confirmations, respectively, in lieu of having the City terminate them; and

**Whereas**, if the effective dates of the Morgan Stanley Confirmations and the SBS Confirmations are extended beyond March 1, 2010 to coincide with the anticipated issuance of Sewage System Bonds and Water System Bonds, the financial benefits to Morgan Stanley and SBS contained in economic terms of the Morgan Stanley Confirmations and the SBS Confirmations, respectively, will be diminished; and

**Whereas**, in the 2006 Swap Resolution the City Council acknowledged the risks, including termination risk, associated with Approved Interest Rate Exchange Agreements and Transactions thereunder, such as the Morgan Stanley Confirmations and the SBS Confirmations; and

**Whereas**, the City's Swap Management Plan recognizes the authority of the Finance Director to manage risks associated with interest rate exchange agreements, including termination risk; and

**Whereas**, because the 2006 Swap Resolution contained parameters and requirements that do not encompass actions which are now in the best financial interest of the City, it is necessary to amend and supplement the 2006 Swap Resolution in order to allow the Finance Director to manage the risks associated with the Morgan Stanley Confirmations and the SBS Confirmations in accordance with the Swap Management Plan.

NOW, THEREFORE, BE IT RESOLVED BY THE COUNCIL THAT:

**Section 1. Definitions.** Capitalized terms used and not otherwise defined herein, including in the recitals hereto, shall have the meanings ascribed to them in the 2006 Swap Resolution.

**Section 2. Management of Morgan Stanley Confirmation and SBS Confirmation Risks.** The Finance Director is hereby authorized to manage the risks associated with the Morgan Stanley Confirmations and SBS Confirmations by modifying the effective dates, the payment dates and period end dates, the fixed rates payable by the City, other payments payable by the City, or floating rates received by the City contained therein, or making any other changes thereto approved by the Finance Director and determined by the Finance Director not to be materially adverse to the City or to materially increase the risks to the City described in Section 5 hereof, subject to the requirements set forth in the 2006 Swap Resolution, except that the effective date of any Forward Transaction or amended Forward Transaction in Section 3(b)(3) thereof shall be changed to a date not later than July 1, 2013.

**Section 3. Payments Related to Management of Morgan Stanley Confirmation and SBS Confirmation Risks.** The Finance Director is authorized to make payment to Morgan Stanley and SBS in consideration for the extension of the effective date of the Morgan Stanley Confirmations and the SBS Confirmations, as applicable, and to pay any necessary fees and expenses in connection with any of the actions authorized herein, whether in the form of a single payment at the time of taking such action, or in the form of multiple payments over time, provided that such payment is taken into account in making the certifications required hereunder. Any such payment shall be made from the sources and shall be secured as provided in the Morgan Stanley ISDA Agreements and the SBS ISDA Agreements, as applicable, and shall be deemed to be a termination payment for purposes of the Morgan Stanley ISDA Agreements and the SBS ISDA Agreements, as applicable.

**Section 4. Conditions Precedent to Swap Management Actions.** The authorizations contained in this resolution shall be subject to the condition that the Finance Director certify as follows: (a) that the proposed action is in the best financial interests of the City; (b) that any new or amended Transaction meets the requirements of the 2006 Swap Resolution, as amended hereby; and (c) that any new or amended Transaction complies with the City's Swap Management Plan, the City's Debt Management Plan, Act 34, and the Sewer Bond Ordinance or the Water Bond Ordinance, as applicable.

**Section 5. Acknowledgement of Risks Associated with Swap Agreements.** The Council acknowledges the potential risks associated with the interest rate agreements, including the amendments to Forward Transactions authorized herein, including, counterparty risk, termination risk, rollover risk, basis risk, tax event risk, and amortization risk, as set forth in the Swap Management Plan.

**Section 6. Additional Authorization.** The Mayor, City Clerk, Finance Director, Treasurer, Corporation Counsel, Director of the Water and Sewerage

Department, any such officials acting in an interim or acting capacity, other officials of the City, their deputies and staff, or any of them, are hereby authorized to execute and deliver such certificates, documents, instruments, opinions and other papers as may be deemed necessary or appropriate to give effect to the transactions contemplated by this Resolution, as determined by such officials executing and delivering the foregoing items. Any of the foregoing officers are authorized to engage the services of financial or legal advisors to the extent deemed necessary or advisable in connection with the actions authorized herein, subject to the payment provisions of Section 3 hereof.

**Section 7. Affirmation; Repeal; Savings Clause.** The 2006 Swap Resolution is hereby affirmed, except to the extent modified herein. All other ordinances, resolutions or orders, or parts thereof, in conflict with the provisions of this Resolution are, to the extent of such conflict, hereby repealed.

**Section 8. Publication.** This Resolution shall be published in full in the Detroit Legal News, a newspaper of general circulation in the City qualified under State law to publish legal notices, promptly after its adoption.

**Section 9. Effective Date.** This Resolution shall be effective immediately upon adoption.



***Change in accounting estimate***

During the year ended June 30, 2008, the City changed its estimate of the allocation of pension related costs between the Water and Sewage Disposal enterprise funds. Such a change in accounting estimate impacts the allocation of the net pension asset, pension obligation certificate payable, annual pension expense, and interest expense on the pension obligation certificates. In prior years, the allocation of these amounts was based on the actuarial valuation's allocation of pension assets, actuarial accrued liabilities, and annual required contribution. Upon further evaluation, the City believes it would be more appropriate to allocate all related assets, liabilities and expenses based on the current allocation of employee payroll costs between the two funds.

The net impact of this change in estimate (allocation) to each fund as of July 1, 2007 was \$8.1 million and was reported as an interfund transfer (transfer from the Sewage Disposal Fund to the Water Fund). The impact of this change in estimate to the pension obligation certificates issuance costs, net pension asset, and pension obligation certificates payable was reported as a reclassification as of July 1, 2007 as follows:

Statement of net assets caption	Amounts previously reported at June 30, 2007	Reclassification	Amounts reported at July 1, 2007
Sewage Disposal Fund:			
Pension obligation certificates issuance costs..... \$	476,644	\$ 4,326,052	\$ 4,802,696
Net pension asset.....	11,424,380	70,639,426	82,063,806
Pension obligation certificates payable, net .....	9,139,646	83,029,390	92,169,036
Water Fund:			
Pension obligation certificates issuance costs.....	8,574,202	(4,326,052)	4,248,150
Net pension asset.....	146,055,290	(70,639,426)	75,415,864
Pension obligation certificates payable, net .....	164,365,382	(83,029,390)	81,335,992

**5. Derivatives Not Reported at Fair Value**

***Interest Rate Swaps***

The City is party to derivative instruments consisting of interest rate swaps that are intended to effectively convert variable-rate financings to fixed-rate financings. These are not reported at fair value on the statement of net assets at June 30, 2008.

**Objective of the swaps:** In order to better manage its interest rate exposure and to reduce the overall costs of its financings, the City has entered into thirty-two separate pay-fixed, receive-variable interest rate swaps. During the year ended June 30, 2008, the City also entered into five separate "pay-variable, receive-fixed" interest rate swaps, to avoid termination on existing related swaps.

**Market access risk:** The City is exposed to market access risk on its hedge swaps or forward starting swaps in the event that it will not be able to enter credit markets or in the event that the credit will become more costly.

**Terms, fair values, and credit risk:** Certain key terms, fair values, and counterparty credit ratings relating to the outstanding swaps as of June 30, 2008 are presented on the following page. The notional amounts of the swaps, except those with effective dates of March 1, 2010 and July 1, 2011 match the principal amounts of the outstanding financings. The swaps with effective dates of March 1, 2010 and July 1, 2011 were entered into to hedge future interest rate risk and will be associated with financings expected to be issued prior to the effective dates. Except as discussed under rollover risk, the City's swap agreements contain scheduled reductions to outstanding notional amounts that match scheduled or anticipated amortization of associated financings.

**City of Detroit, Michigan**  
**NOTES TO BASIC FINANCIAL STATEMENTS**  
**June 30, 2008**

Associated Financing Issue	Notional Amounts (1)	Effective Date	Fixed Rate Paid	Variable Rate Received	Fair Values	Swap Termination Date	Final Maturity of Bonds	Counterparty Credit Rating
Building Authority Series 1999-A	\$ 26,900,000	4/23/2004	7.480%	65% <sup>2</sup> LIBOR	\$ (10,581,860)	7/1/2029	7/1/2029	Aa3/AA-/AA-
Water 2001-C	113,360,000	6/7/2001	4.900%	SIFMA (2) + 0.0%	(18,052,159)	7/1/2026	N/A	Aa3/AA-/AA-
Water 2001-C Offsetting Swap (4)	113,360,000	5/14/2008	SIFMA(2) + 0.0%	3.498%	(2,075,720)	7/1/2026	N/A	Aa3/AA-/AA-
Sewage 2001 C-1	155,305,000	10/23/2001	4.428%	SIFMA (2)+ 0.0%	(17,711,686)	7/1/2027	7/1/2027	Aa2/AA-/AA
Sewage 2001 C-2	123,625,000	10/23/2001	4.468%	SIFMA (2)+ 0.0%	(15,421,922)	7/1/2029	N/A	Aa2/AA-/AA
Sewage 2001 C-2 Offsetting Swap (4)	123,625,000	5/8/2008	SIFMA(2) + 0.0%	3.578%	(3,089,327)	7/1/2029	N/A	Aa2/AA-/AA
Sewage 2001 D-1	20,000,000	7/1/2008	4.656%	SIFMA (2) + 0.0%	(2,155,728)	7/1/2032	7/1/2032	Aa1/AA/AA
Sewage 2001 D-2	72,450,000	7/1/2012	4.831%	SIFMA (2) + 0.0%	(5,126,366)	7/1/2032	7/1/2032	Aa1/AA/AA
Water 2003-B	1,980,000	1/30/2003	3.020%	CPI + 1.01%	68,809	7/1/2009	7/1/2009	Aa3/AA-/AA-
Water 2003-B	2,290,000	1/30/2003	3.310%	CPI+ 1.12%	90,297	7/1/2010	7/1/2010	Aa3/AA-/AA-
Water 2003-B	2,500,000	1/30/2003	3.550%	CPI + 1.25%	117,001	7/1/2011	7/1/2011	Aa3/AA-/AA-
Water 2003-B	2,175,000	1/30/2003	3.740%	CPI + 1.33%	107,715	7/1/2012	7/1/2012	Aa3/AA-/AA-
Water 2003-B	2,800,000	1/30/2003	3.870%	CPI + 1.34%	140,209	7/1/2013	7/1/2013	Aa3/AA-/AA-
Water 2003-B	2,505,000	1/30/2003	4.000%	CPI + 1.36%	113,800	7/1/2014	7/1/2014	Aa3/AA-/AA-
Water 2003-C	2,005,000	1/30/2003	3.870%	CPI + 1.34%	100,441	7/1/2013	7/1/2013	Aa3/AA-/AA-
Water 2003-C	2,330,000	1/30/2003	4.000%	CPI + 1.36%	105,849	7/1/2014	7/1/2014	Aa3/AA-/AA-
Sewage 2003-B	150,000,000	5/22/2003	3.842%	SIFMA (2) + 0.0%	(9,148,117)	7/1/2033	7/1/2033	Aa2/AA-/AA-
Water 2005-B	195,000,000	4/1/2005	4.710%	SIFMA (2) + 0.0%	(23,055,489)	7/1/2035	N/A	Aa3/AA-/AA-
Water 2005-B Offsetting Swap (4)	195,000,000	5/6/2008	SIFMA(2) + 0.0%	3.652%	(4,560,188)	7/1/2035	N/A	Aa3/AA-/AA-
Water 2006-B	120,000,000	3/1/2007	5.000%	SIFMA (2) + 0.0%	(20,449,231)	7/1/2036	7/1/2036	Aa3/AA-/AA-
Sewage 2006-A	125,000,000	8/10/2006	4.551%	SIFMA (2) + 0.0%	(3,904,341)	7/1/2036	N/A	Aa1/AA/AA
Sewage 2006-A Offsetting Swap (4)	125,000,000	5/7/2008	SIFMA(2) + 0.0%	3.6908%	2,155,728	7/1/2036	N/A	Aa1/AA/AA
Sewage 2006-D	361,315,000	12/14/2006	4.105%	67% <sup>3</sup> LIBOR + .60%	(11,565,998)	7/1/2032	7/1/2032	A2/AA-/AA
Sewage Head Swap (3)	56,250,000	3/1/2010	4.927%	SIFMA (2) + 0.0%	(6,880,862)	7/1/2039	N/A	A1/A+/A+
Sewage Head Swap (3)	168,750,000	3/1/2010	4.927%	SIFMA (2) + 0.0%	(20,067,871)	7/1/2039	N/A	Aa3/AA-/AA
Water Hedge Swap (3)	150,000,000	3/1/2010	4.932%	SIFMA (2) + 0.0%	(17,938,495)	7/1/2039	N/A	A1/A+/A+
Water Hedge Swap (3)	50,000,000	3/1/2010	4.932%	SIFMA (2) + 0.0%	(6,149,598)	7/1/2039	N/A	A1/A+/A+
Water Hedge Swap (3)	76,510,000	7/1/2011	4.869%	SIFMA (2) + 0.0%	(5,282,605)	7/1/2029	N/A	A1/A+/A+
Water Offsetting Swap (4)	76,510,000	7/1/2011	SIFMA(2) + 0.0%	3.998%	(952,075)	7/1/2029	N/A	A1/A+/A+
Pension Obligation Certificates-GRS	96,621,000	6/12/2006	6.256%	3 MTH LIBOR + .34%	(13,884,219)	6/15/2034	6/16/2034	A1/A+/A+
Pension Obligation Certificates-PFRS	153,801,500	6/12/2006	6.252%	3 MTH LIBOR + .34%	(21,445,113)	6/15/2034	6/15/2034	A1/A+/A+
Pension Obligation Certificates-PFRS	104,325,500	6/12/2006	6.223%	3 MTH LIBOR + .30%	(12,957,535)	6/15/2029	6/15/2029	A1/A+/A+
Pension Obligation Certificates-GRS	45,252,000	6/12/2006	6.223%	3 MTH LIBOR + .30%	(5,923,757)	6/15/2029	6/15/2029	A1/A+/A+
Pension Obligation Certificates-PFRS	153,801,500	6/12/2006	6.252%	3 MTH LIBOR + .34%	(22,041,578)	6/15/2034	6/15/2034	Aaa/A+/A+
Pension Obligation Certificates-PFRS	104,325,500	6/12/2006	6.223%	3 MTH LIBOR + .30%	(13,033,970)	6/15/2029	6/15/2029	Aaa/A+/A+
Pension Obligation Certificates-GRS	96,621,000	6/12/2006	6.256%	3 MTH LIBOR + .34%	(13,497,975)	6/15/2034	6/15/2034	Aaa/A+/A+
Pension Obligation Certificates-GRS	45,252,000	6/12/2006	6.223%	3 MTH LIBOR + .30%	(6,033,095)	6/15/2029	6/15/2029	Aaa/A+/A+

1. Notional amount balance as of June 30, 2008.
2. The Securities Industry and Financial Markets Association Index Rate.
3. Denotes that the swap termination date does not match the final maturity of the financings. Swaps are issued in anticipation of a future planned variable rate bond issue.
4. Denotes bonds with pay-variable, receive-fixed terms. All others are pay-fixed, receive-variable terms.

**Fair Value:** Because interest rates have generally declined since the time the swaps were negotiated, many of the City's swaps have a negative fair value as of June 30, 2008. The negative fair values may be countered by lower total interest payments required under the variable-rate financing, creating lower synthetic interest rates. The fair value was estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swap.

**Credit Risk:** When the fair value of any swap has a positive value, then the City is exposed to the risk that the counterparty will not fulfill its obligations. As of June 30, 2008, the City was exposed to \$2,999,849 of credit risk (without regard to collateral or other security arrangements). The table above shows the credit quality ratings of the counterparties to each swap. The City uses six different counterparties, as one way of diversifying its credit risks. In addition, the swap agreements contain varying collateral agreements with the counterparties. The swaps require full collateralization of the fair value of the swap should the counterparty's credit rating fall below certain rating levels by

Fitch Ratings, Standard & Poor's, and /or Moody's Investors Service. Collateral on all swaps is to be in the form of U.S. government securities held by a third - party custodian.

**Basis Risk:** The City is exposed to basis risk when the variable interest received on a swap is based on a different index than the variable interest rate to be paid on the associated variable rate debt obligation. At June 30, 2008 the associated debt used the same index for all Securities Industry and Financial Markets Association Municipal Swap Index (SIFMA) and Consumer Price Index (CPI) referenced swaps, as well as the Pension obligation certificates (based on LIBOR) in the table above. As a result, there is no significant exposure to basis risk as of June 30, 2008.

**Termination Risk:** The City or counterparty may terminate any of the swaps if the other party fails to perform under the terms of the contract. In such cases, the City may owe or be due a termination payment depending on the value of the swap at that time. If any of the swaps were terminated, the associated variable-rate financings would no longer carry synthetic interest rates.

For the swaps associated with the Water 2001-C and 2001-C Offsetting (mirror), the Fund pays a lower fixed rate in exchange for granting the counterparty a special termination option. Under this option, the counterparty can terminate the swap without payment if the SIFMA averages 7 percent or higher for a consecutive 180-day period. The termination provision for the swap associated with Water 2001-C becomes effective after January 1, 2010, while the 2001-C Offsetting (mirror) is currently effective.

For the swaps associated with the Sewage 2001 C-1, 2001 C-2, 2001 C-2 Offsetting (mirror), and 2003-B issuances, the Fund pays a lower fixed rate in exchange for granting the counterparty a special termination option. Under this option, the counterparty can terminate the swap without payment if SIFMA averages 7 percent or higher for a consecutive 180-day period. The termination provision for the swap associated with Sewage 2003-B, is effective after July 1, 2013, while the others are effective after January 1, 2010.

**Rollover Risk:** The City is exposed to rollover risk on swaps that mature or may be terminated prior to the maturity of the associated financings. When these swaps terminate, or in the case of the termination option, if the counterparty exercises its option, the City will not realize the synthetic rate offered by the swaps on the underlying issues. The Fund is exposed to rollover risk on GRS and PRS swaps should they be terminated prior to the maturity of the associated financings (POCs). See note IV for further discussion on terminating events of the GRS and PRS Swaps.

### ***Swaptions***

#### **Objectives of the Swaptions:**

In addition to the interest rate swaps described above, the City entered into five (5) swaptions in conjunction with the termination of previous interest rate swaps. Specifically, the City entered into one interest rate swap in February 2003 and two interest rate swaps in April 2004 related to the issuance of variable rate water bonds. Those interest rate swap agreements included provisions that allowed for the counterparty to put the City into a swaptions arrangement upon termination. Upon the restructuring of the water variable rate bonds in August 2006 to fixed-rate bonds, the interest rate swaps were terminated and the counterparty executed the swaptions. Likewise, when the two sewer variable rate bonds were restructured in December 2006 to fixed-rate bonds, the interest rate swaps were terminated, and the counterparty executed the swaptions provision. The swaptions give the counterparty the option to make the City enter into a pay-variable, receive-fixed interest rate swap. If the option is exercised, the Fund may consider the potential to issue variable rate refunding bonds and terminate the swaption, but is not committed to doing so.

**Terms, Fair Value, and Credit Risk:** The counterparty has the option to exercise the sewer agreements on any date in which the SIFMA index has averaged 7.00% or higher for a consecutive 90 day period. The counterparty has the option to exercise the water agreements any date in which the SIFMA index has averaged 7.00% or higher for a consecutive 180 day period. Certain other key terms, fair values, and counterparty credit ratings related to the outstanding swaptions as of June 30, 2008 are presented below. If the options are exercised by the counterparty, the underlying swap agreements contain scheduled reductions to the outstanding notional amounts that match scheduled or anticipated amortization of associated financings.

City of Detroit, Michigan  
NOTES TO BASIC FINANCIAL STATEMENTS  
June 30, 2008

Associated Financing Uses	Notional Amounts (1)	Option Effective Date	Variable Rate Paid	Fixed Rate Received	Fair Values	Swap Termination Date	Counterparty Credit Rating
Water 2003-D	149,655,000	7/2/2011	SIFMA(2)+0.0%	4.06%	(8,010,829)	7/1/2033	Aaa/AA/AA-
Water 2004-A	77,010,000	7/1/2005	SIFMA(2)+0.0%	3.94%	(1,848,674)	7/1/2025	Aaa/AA/AA-
Water 2004-B	158,490,000	7/1/2005	SIFMA(2)+0.0%	3.845%	(2,809,665)	7/1/2023	Aaa/AA/AA-
Sewage 1998-A	67,500,000	7/1/2008	SIFMA(2)+0.0%	4.512%	(1,385,532)	7/1/2023	Aa3/AA-/AA-
Sewage 1998-B	67,500,000	7/1/2008	SIFMA(2)+0.0%	4.512%	(1,374,597)	7/1/2023	Aa3/AA-/AA-

1. Notional amount balances as of June 30, 2008.

2. The Securities Industries and Financial Markets Municipal Swap Index.

**Fair Value:** The fair value was estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for the hypothetical zero-coupon bonds due on the date of each future net settlement on the swap.

**Market-access risk:** If the options to enter into interest rate swap agreements are exercised by the counterparty and variable rate refunding bonds are not issued by the City, the Fund would make net swap payments as required by the terms of the contract – that is, making a variable payment of the SIFMA index rate (unadjusted) to the counterparty for the term of the respective swap and receiving a fixed payment.

## 6. Other Information

- a. Automobile Parking Fund** - The City has covenanted in bond authorizing documents to charge for the use of and services provided by the City of Detroit Building Authority Parking Arena System (the System) for each fiscal year of the City such that the gross revenues collected and remitted to the trustee (1) will be at least sufficient to at all times pay when due the principal, interest, and sinking fund installments on the revenue bonds without recourse to the Debt Reserve Account, to pay or provide for all operating expenses, to maintain the System in good repair without recourse to the Operating and Contingency Reserve Fund, and to replenish the Debt Reserve Account (so as to satisfy the corresponding reserve requirement) and the Operating and Maintenance Reimbursement Fund, and (2) will, after replenishment of any deficit in the Debt Reserve Account, Operating and Contingency Reserve Fund, and the Operating and Maintenance Reimbursement Fund, be equal to or greater than 175% of the amount payable in such fiscal year as the principal of sinking fund installments for the interest on all revenue bonds, net of amounts capitalized for interest payable during the construction period.

The City has covenanted further that if the fees and charges collected in any fiscal year are not sufficient to produce such revenues, the City will employ a consulting expert to submit recommendations as to revision of the schedule of fees then in effect and the City will thereafter charge and collect fees in accordance with such recommendation. The schedule of charges for the System may not be revised for a period of two years unless (1) such revision is for purpose of complying with the aforesaid rate covenant or, simultaneous with such revision, there is filed with the trustee a certificate of the consulting expert stating the opinion that if such revision had been in effect during the whole of the fiscal year immediately prior thereto, the revenues collected during such fiscal year would not have been diminished, and (2) at the time of any reduction in charges, the amounts in the Debt Reserve Account and Operating and Contingency Reserve Fund equal or exceed the reserve requirements.

The revenue bond documents specify that additional bonds may be issued by the Fund for the purpose of financing additions, replacements, and improvements to the City of Detroit Building Authority Parking Arena System, provided that the trustee shall have received all legally required authorized opinions and certificates and that the estimated gross revenues (as defined in the bond authorizing documents) for the five years following completion of the facilities will be at least (1) 175% of annual debt service on all parity outstanding bonds, or (2) the sum of annual debt service on all parity outstanding bonds (including the Additional Bonds) plus the amount necessary to make all required payments to the various funds maintained by the trustee, whichever is greater. Other than as described above, the Parking Fund may not issue any obligations secured by gross revenues from the System unless any resulting lien on the System's gross revenues is expressly subordinate to liens for the bondholders' or bank's benefit as described above.

- b. **Sewage Disposal and Water Funds Construction Programs** - The Sewage Disposal Fund is engaged in a variety of projects that are a part of its five-year Capital Improvement Program (the Program). The total cost of this Program is anticipated to be approximately \$2.11 billion through fiscal year 2013. The Program is being financed primarily from revenues of the Fund and proceeds from the issuance of revenue bonds. The total amount of construction contract commitments outstanding at June 30, 2008 was approximately \$421 million.

The Water Fund is engaged in a variety of projects that are a part of its five-year Capital Improvement Program (the Program). The total cost of this program is anticipated to be approximately \$2.15 billion through fiscal year 2013. The Program is being primarily financed from revenues of the Fund and proceeds from the issuance of revenue bonds. The total amount of construction contract commitments outstanding at June 30, 2008 was approximately \$155 million.

- c. **Pension Plans** - The City of Detroit Retirement System consists of the General Retirement System (GRS) and the Police and Fire Retirement System (PFRS). Each system is a single-employer plan composed of a Defined Benefit Plan and a Defined Contribution Annuity Plan. The plans provide retirement, disability, and death benefits to plan members and beneficiaries. The Systems issued publicly available financial reports that include financial statements and the required supplementary information. The reports can be obtained from City of Detroit Retirement Systems, 2 Woodward Avenue, Coleman A. Young Municipal Center, Room 908, Detroit, Michigan 48226.

These plans are administered in accordance with the City Charter and union contracts, which assign the authority to establish and amend contributions and benefit provisions to each plan's Board of Trustees. The Systems' investment policies are governed in accordance with the State Public Act 314 of 1965, as amended.

The plans' financial statements are prepared using the accrual basis of accounting. Plan member contributions are recognized in the period in which the contributions are due. Employer contributions are recognized when due and the City has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable, in accordance with the terms of each plan.

Plan investments are reported at fair value. Short-term investments are reported at cost, which approximates fair value. Securities traded on a national or international exchange are valued at last reported sales price at current exchange rates. Mortgages are valued on the basis of future principal and interest payments and are discounted at prevailing interest rates for similar investments. Investments that do not have an established market are reported at estimated fair value. Approximately 29 percent of the General Retirement System's assets and 25 percent of the Police and Fire Retirement System's assets are not publicly traded and, therefore, do not always have a readily determined market value.

The City's policy is to fund normal costs and amortization of prior service costs, based on an actuarially determined rate. The contribution rates for the fiscal year ended June 30, 2008 was 10.21% of active annual payroll for the General Retirement System and 25.09% of active annual payroll for the Police and Fire Retirement System. Contributions from City funds and the Detroit Public Library fund, including accounts receivable for the year ended June 30, 2008, amounted to \$43,168,448 and \$41,113,934 for the General Retirement System and the Police and Fire Retirement System, respectively.

Employee contributions elections for annuity savings are as follows:

- **General Retirement System** — Employees may elect to contribute 3%, 5%, or 7% of the first \$97,500 representing the annual Social Security wage base \$97,500 of annual FY 2008 compensation and 5% or 7% of any excess over \$94,200 and \$97,500 respectively. Contributions are voluntary for all union and non-union employees. Contributions received from General Retirement System employees during the year ended June 30, 2008 amounted to \$20,358,640.
- **Police and Fire Retirement System** — Mandatory contributions are 5% of base compensation until eligibility for retirement is reached. Contributions received from Police and Fire Retirement System employees during the year ended June 30, 2008 amounted to \$10,299,360.

## Schedule 4

City of Detroit, Michigan

## Changes in Fund Balances of Governmental Funds

Last Ten Fiscal Years

(Modified Accrual Basis of Accounting)

(Unaudited)

	Fiscal Year				
	2008	2007	2006	2005	2004
<b>Revenues</b>					
Taxes:					
Property Taxes.....	\$ 225,890,313	\$ 257,003,325	\$ 243,621,932	\$ 238,771,142	\$ 249,372,955
Municipal Income Tax.....	276,485,035	278,309,191	284,111,220	282,501,875	290,614,837
Utility Users' Tax.....	51,590,599	53,768,977	60,019,626	52,939,839	50,473,815
Wagering Taxes.....	180,365,237	179,763,570	156,588,917	137,970,347	116,145,598
Gas and Weight Tax.....	61,070,748	62,080,522	62,804,995	63,476,425	65,806,351
Other Taxes and Assessments.....	13,283,748	16,201,899	13,583,421	13,565,118	14,911,156
State Hotel and Liquor Tax.....	16,220,140	17,579,292	16,287,676	16,310,767	16,217,263
State Shared Taxes.....	249,027,299	272,084,669	279,467,063	282,914,217	286,479,535
Shared Taxes-Liquor and Beer Licenses.....	573,613	550,391	1,351,158	602,582	528,355
Interest and Penalties on Taxes.....	10,857,112	10,342,478	9,181,155	11,491,470	13,969,136
Licenses, Permits and Inspection Charges.....	34,565,327	31,986,424	34,233,992	35,006,518	29,463,914
Intergovernmental:					
Federal.....	222,675,031	219,592,658	218,119,145	276,372,474	253,620,853
State.....	41,062,686	41,878,552	75,774,530	36,867,375	64,707,175
Health.....	-	-	-	-	-
State Equity Grant.....	-	-	-	1,076,931	982,701
Other.....	4,026,591	14,359,711	25,192,384	16,346,773	36,215,990
Sales and Charges for Services.....	258,599,558	243,533,764	189,253,428	183,294,833	190,928,138
Ordinance Fines and Forfeitures.....	20,850,629	25,680,231	21,525,257	27,481,642	28,237,898
Revenue from Use of Assets.....	13,560,617	37,634,876	22,780,845	16,782,057	28,696,431
Investment Earnings.....	19,189,619	24,075,811	18,396,691	14,464,802	4,500,270
Other Revenue.....	73,606,042	123,867,578	106,521,883	131,657,892	124,787,604
Total Revenues.....	1,773,499,944	1,910,293,919	1,838,815,318	1,839,895,079	1,866,659,975
<b>Expenditures</b>					
Current:					
Public Protection.....	660,230,564	654,137,306	687,251,414	1,423,581,547	738,330,832
Health.....	157,414,372	154,283,807	177,723,221	197,473,468	172,301,527
Recreation and Culture.....	21,265,879	24,648,968	55,390,716	99,296,179	73,769,563
Economic Development.....	99,342,897	86,454,732	88,424,272	99,655,593	96,272,459
Educational Development.....	57,388,638	58,021,384	64,427,129	77,259,012	95,579,152
Housing Supply and Conditions.....	9,607,906	8,412,644	14,786,461	27,863,296	21,150,047
Physical Environment.....	202,986,951	197,682,760	220,208,683	301,784,627	232,268,536
Transportation Facilitation.....	58,595,880	72,482,752	79,343,398	46,272,594	49,857,971
Development and Management.....	298,231,422	310,231,013	233,297,837	495,348,897	387,713,093
Debt Service:					
Principal.....	140,216,435	95,599,337	88,150,364	73,544,336	81,450,470
Interest.....	110,841,259	138,408,774	120,956,704	51,462,415	53,075,658
Bond Issuance Costs.....	3,182,053	-	56,147,009	44,262,505	5,591,428
Capital Outlay.....	88,458,549	69,848,815	175,169,666	282,545,708	162,593,794
Total Expenditures.....	1,907,762,805	1,870,212,292	2,061,276,874	3,220,350,177	2,169,954,530
Excess (Deficiency) of Revenues Over Expenditures.....	(134,262,861)	40,081,627	(222,461,556)	(1,380,455,098)	(303,294,555)
<b>Other Financing Sources(Uses)</b>					
Sources:					
Transfers In.....	208,766,473	176,069,587	129,799,480	141,075,789	162,683,542
Pension Obligation Certificates Issued.....	-	-	771,087,137	1,170,607,421	-
Swap Termination Fee.....	-	-	38,969,807	-	-
Proceeds of Section 108 Federal Note.....	-	14,958,000	1,800,000	7,789,000	-
Proceeds of Capital Leases.....	-	-	34,892,659	315,351	24,541,150
Proceeds from Debt Issuance.....	281,783,578	-	81,903,071	353,830,000	347,398,138
Premium from Debt Issuance.....	4,974,370	-	3,778,114	13,014,675	18,570,675
Total Other Financing Sources.....	495,524,421	191,027,587	1,062,230,268	1,686,632,236	553,193,505
Uses:					
Transfers Out.....	(310,205,006)	(247,789,783)	(165,027,112)	(230,661,095)	(239,791,578)
Transfer to primary government.....	-	-	-	-	-
Payment to Refunded Bond Escrow's Agent.....	-	-	-	-	-
Bond Issuance Costs.....	-	-	-	-	-
Principal Paid to Bond Agent for Refunded Bonds.....	(72,410,000)	-	(764,864,391)	(161,800,000)	(120,725,000)
Interest Paid to Bond Agent for Refunded Bonds.....	(1,314,181)	-	(1,741,161)	(10,865,420)	(2,874,682)
Total Other Financing Uses.....	(383,929,187)	(247,789,783)	(931,632,664)	(403,326,515)	(363,391,260)
Total Other Financing Sources (Uses).....	111,595,234	(56,762,196)	130,597,604	1,283,305,721	189,802,245
Special Item-Casino Development Revenue.....	-	-	-	-	38,250,000
Net Change in Fund Balances.....	(22,667,627)	(16,680,569)	(91,863,952)	(97,149,377)	(75,242,310)
Fund Balance at Beginning of Year.....	157,501,503	173,203,805	275,260,877	387,838,195	456,395,275
Prior Year Adjustment/Accounting Change.....	-	-	-	-	-
Increase (Decrease) in Inventories.....	1,673,819	978,267	(10,193,120)	(15,454,941)	6,685,230
Fund Balance at End of Year.....	\$ 136,507,695	\$ 157,501,503	\$ 173,203,805	\$ 275,233,877	\$ 387,838,195

Source: City of Detroit, Comprehensive Annual Financial Reports for Fiscal Years ending June 30, 1999 through 2008

See accompanying independent auditors' report.